CHAPTER 1: INTRODUCTION

1.1 Background

Despite enormous amounts of international aid, development indicators in a significant number of developing countries are continuing to stagnant, or even decline. The most recent work in development economics and aid policy literature have singled out the quality of a country's institutions as the most important attribute of its development path (World Bank, 1997; Easterly, 2001; Olson, 2000; Easterly and Levine, 2001; Van de Walle, 2001; Rodrik 2002; Kaufmann and Kraay, 2002; Rodrik, 2006). Similarly, a large number of aid evaluations contend that aid has been less successful because donors have failed to understand the importance of a country's institutional foundations, and how aid can enhance or *undermine* its long-term economic performance. Furthermore, where a country has failed, or is on a failing path, economists and policy makers alike have most recently pointed to dysfunctional or nascent underlying political, social, and economic institutions to be the main cause of its underdevelopment and collapse.

Thus, the latest conventional wisdom in the development economics and policy literature is that *institutions matter most* to development. As a consequence, development aid policy is now following this consensus and slowly altering the nature, direction and assumptions of aid interventions. However, this sudden 'discovery' and focus on institutions should not be perceived as the 'magic bullet'. In fact, it is a mere first step in the quest for a better understanding of the central development questions; why do some countries develop, whilst others stagnate, and how can external agents best assist to alleviate poverty?

To be clear, the complexity of designing aid interventions that can influence better institutional development as a base for sustainable poverty alleviation needs to be emphasised. Institutional change is difficult conceptually and in practice. Even in developed countries, the multifaceted nature of institutions and their dynamic evolution is difficult for scholars and governments to analyse and manipulate through policies and programs. In developing and transitional countries, where institutions most often reflect an uncomfortable fusion of traditional, colonial and Western influence, it is even more difficult for external aid donors to comprehend the process of change and then design and implement programs that can successfully influence a recipient country's institutions. There is no consensus yet in the institutional economic and development literature on *how* institutions evolve, and taking this one step further, *how* foreign aid can best influence institutions to enhance development. By itself, this latest consensus on development aid policy seems limited to a broad understanding that institutional development is a critical pre-requisite to development. Nevertheless, there have been a few recent attempts to undertake analysis and develop frameworks to guide improved development aid. Assessment of this analysis, and related frameworks, is the central purpose of this thesis.

The institutional economics literature points to the slow and incremental development of political, social and economic institutions, and importance of these institutions being developed endogenously, influenced by the incentive structures that face economic agents. This literature portrays aid as having a negative or positive effect on a countries' development, depending on how aid is positioned to influence decision making and behaviour in the recipient country. The development aid policy literature has primarily sought to deal with this emerging consensus through the fragile state paradigm. This paradigm is primarily concerned with how aid interventions could be designed differently to address non-market failure in countries with dysfunctional institutions, and those characterised by poor development indicators, and thus low aid effectiveness. The fragile state paradigm draws on both the institutional economics literature and on state-building approaches where the former concentrates on the incremental evolution of institutions, and the latter is concerned with stabilising and developing a country through large scale capacity substitution interventions.

This thesis seeks to separately explore the institutional economics and development aid policy literature and then compare and contrast their respective conclusions for aid interventions. It will specifically evaluate the utility and effectiveness of incentive-based approaches and the fragile state paradigm from a theoretical and practical perspective. Drawing on these findings, the thesis then attempts to develop a new framework that could be used to analyse the optimal level and type of aid using a non-market failure model. This model acknowledges that aid can have a positive and negative institutional effect and that interventions ultimately need to find equilibrium. This theory and conclusions are then examined in the context of aid interventions in Papua New Guinea (PNG) – widely considered to exhibit the characteristics of a 'so-called' fragile state.

Although this thesis is concerned with the discrete role of aid in development, aid should not be perceived as a panacea for development in itself. On a global scale, aid is dwarfed by international trade and financial flows and in most cases by the domestic resources of the recipient country. It is acknowledged, based on historical evidence, that the aid sector alone will never be able to deliver sustainable development for another country without it being led and sustained by internal economic, social and political development. It is also accepted that each country will have a different path. For instance, China achieved high growth with limited aid, whilst Botswana achieved high growth with a high level of aid per capita. Nevertheless, in all cases, success has been built on well formed institutions. The challenge is of course how to get these institutions in the first place and whether aid can play a role. This challenge is the primary concern of this thesis.

1.2 Outline of the Thesis

This thesis is organised into two broad parts. Chapters 2, 3 and 4 focus on the theory underlying institutional economics, development aid policy and how these bodies of literature relate to each other in a practical way to influence positive change in fragile states at a global level. In contrast, chapters 5, 6 and 7 seek to evaluate aid effectiveness in PNG, with a focus on aid interventions by Australia, PNG's largest donor. Chapter 8 seeks to draw the two parts together.

Chapter 2 examines the institutional economics literature, with a concentration on the role of the state. The chapter seeks to explain why institutions are important to the development of a society, and then explores the main theories of institutional development and change. The chapter analyses the contribution of new institutional economics and non-market (government) failure to institutional development in developing countries.

Chapter 3 reviews and analyses both historical and evolving aid donor assumptions about aid effectiveness. The fragile state paradigm is introduced and its policy prescriptions on best practice principles and aid modalities are then examined.

Chapter 4 synthesizes the international economics literature and donor approaches set out in chapters 2 and 3 and then aims to establish points of similarities and departures between theory and practice. The policy to implementation gap between longer-term incentive based and state-building approaches to fragile states will be analysed and discussed. The theory of non-market failure is then applied to aid interventions in various institutional environments in order to assess the costs and benefits of aid and the equilibrium level of aid interventions. The chapter ends with a 'consensual view' on best practice in implementing reform within fragile states.

Chapter 5 introduces the case study on PNG through a 'Drivers of Change' analysis. The chapter explores the development context by examining PNG's existing structures, agents and institutions and then seeks to identify the key constraints and opportunities for influencing change within PNG.

Chapter 6 assesses the effectiveness of current aid interventions in PNG. It employs the non-market failure model introduced in chapter 4 to assess foreign aids' potential to influence institutional change, and draws conclusions on whether aid has had a positive, negative or neutral impact on institutional change at the macro level. The chapter then discusses these conclusions in the context of the fragile state paradigm.

Chapter 7 analyses two large Australian aid interventions in PNG that have attempted to employ incentive-based approaches to influence institutional development in PNG. The chapter seeks to assess overall program effectiveness and emerging lessons.

Chapter 8 concludes the thesis by evaluating the overall usefulness, and limits of, the fragile state paradigm in guiding aid interventions.

Chapter 2: Review of the Institutional Economics Literature

2.0 Introduction

If we lived in an idealised neo-classical world, institutions would not matter to either economic analysis, or economic growth. In a neo-classical world, institutions are irrelevant because the economy is a frictionless entity. Individuals always act rationally. Property rights are perfectly and costlessly enforceable and information asymmetries do not exist. There are no principal-agent problems, for example, between the owners of capital and its managers. Under this model, output is determined by the quality and quantity of production factors and the state of technology, and is not constrained by the quality of institutional frameworks. In this abstract conception of a market economy, the role of the state is minimal.

Critics of the neo-classical paradigm have argued that its models assume away the real world, and thus do not explain variations in economic growth because they ignore *inter alia* the importance of institutions in society (Hoff and Stiglitz, 2001:390-391). It is this so-called 'black box' of institutions that is the primary concern of this chapter. This chapter aims to explore the institutional economics literature and examine why the quality of institutions matter to growth, and ultimately to broader development outcomes.

The chapter itself is divided into five main sections. Section 2.1 attempts to define institutions and consider why they are important to society. Section 2.2 seeks to discuss the main theories of institutional development and change, and assess their relevance to developing countries. Section 2.3 evaluates the institutional economic literature to explore what might be the appropriate role for the state in creating the right incentives for economic growth. Section 2.4 examines theories of change and discusses their implications for policy in developing countries. The chapter ends with some brief concluding remarks in Section 2.5.

2.1 Meaning and Significance of Institutions

Institutions are difficult to conceptualise. They are a fuzzy, intangible and abstract concept. North (1990:3) defines institutions to be:

> the rules of a game in any society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social or economic.

North's definition is widely accepted (Meier, 2001; Grindle, 2001; Bardhan, 2001; Hoff and Stiglitz, 2001; Bromley, 1989: Eggertson, 1990). His definition is sufficiently broad to include both formal rules (constitution, laws, and property rights) and informal rules (customs, taboos, sanctions, traditions and codes of conduct) (North, 1991:97). In fact, it is the fusion of overlapping and interconnected sets of formal and informal rules that make up the actual framework of incentives that shape the institutions within a society. It is the incentives and constraints provided by institutions that decisively influences individual decision-making within society.

Knight (1992:192-193) contends that, in order for a set of rules to be considered an institution, "knowledge of these rules must be shared by the members of the relevant community or society". Taking this definition one step further, it is suggested that the rules not only need to be known, but should also have a degree of acceptance in order to give the institution legitimacy to exercise power and authority (for a broader discussion on 'legitimacy' see Brinkerhoff, 2005:2). This view is consistent with Aoki's (2001) definition of an institution. Aoki (2001: 305) argues that for an institution to exist there needs to be a "self-sustaining system of shared beliefs" or equilibrium point that agents commonly accept.

Institutions are often confused with organisations, but organisations differ in scale, scope and purpose. North (1990:5-7) defines organisations as a group of individuals bound by a common purpose to achieve objectives that are usually created to secure opportunities. Organisations come into existence to take advantage of the institutional framework, and in turn can also act as agents that induce changes in the institutional framework. For example, in a modern state, state-funded law and justice organisations exist to enforce the formal rules of society. How these organisations actually operate will depend on the extent to which the law being enforced by these law and justice organisations reflects the broader informal rules of society - in particular, the social and political framework that determines the actual "rules of the game".

Institutions are important to a society because their associated incentive structure determines the nature of economic relations in a society (North, 1990; World Bank, 1997; Bardhan, 2001; Meier, 2001; Hoff and Stiglitz, 2001; Bardhan, 2001). This argument is founded theoretically on the basis of the transaction costs of economic exchange.

Historical investigation seems to indicate that economic growth requires a degree of human cooperation and environmental stability. Institutions reduce uncertainty by providing a structure for collective human interaction which lends society stability (North, 1990:6). Aoki (2001: 308) views the existence of an institution as controlling an agent's individual choice action rules by coordinating their beliefs. Without a well understood and accepted set of rules, the transaction costs of economic exchange are higher, reducing the incentives to pursue potential economic gains from exchange and innovation. For example, utility-maximising individuals will cooperate with other agents if the play is iterant and some degree of certainty exists. If the game has many players and information asymmetries are large, it will not be completed and people will not cooperate, leading to less economic exchange and lower aggregate welfare. Without functioning institutions, transaction costs are higher and economic activity is accordingly lower.

To achieve economic growth, a society requires institutions to act as enforcement mechanisms to constrain actions outside the rules. Known enforcement mechanisms reduce the incentive to act outside accepted rules, minimising the potential transaction costs associated with economic exchange. North (1990:54) has argued that a society's inability to develop effective, low-cost contract enforcement mechanisms is the most important source of historical stagnation and underdevelopment in the developing world. This conclusion is not surprising since enforcement mechanisms, which have framed economic activities in small traditional societies, are not useful in regulating modern economic exchanges outside the clan unit. Alternatively, if enforcement mechanisms are imported, the formal institutions of a state can take time to be understood and accepted. Limited enforcement is also a case of the state lacking the capacity or the political will to undertake the enforcement function effectively.

However, the presence of a given institution per se does not mean that an institution always plays a positive role in economic growth. An institution can be effective or dysfunctional, or somewhere in between these extremes. In developing countries, where institutions are undergoing rapid transition, the institutional environment is often described as dysfunctional because there is a disjuncture between formal and informal norms, and distributive conflicts between groups over resources. Olson (1982) ascribes the decline of nations as a function of small and powerful interest groups in a society pursuing rent-seeking objectives that maximise their own group interests, rather than pursuing economy-wide wealth creating objectives.

2.2 Theories of Institutional Development and Change

The institutional economics literature has not yet reached consensus on a unified theory of institutional development and change (Hodgson, 2003:xii). Indeed, Williamson (2000:277), a leading institutional economist, contends that we are "still very ignorant about institutions" and suggests that in the absence of consensus we have to accept conceptual pluralism to overcome our ignorance about institutions. Section 2.2 will examine the different theories of institutional development and change.

2.2.1 Genesis of Institutions

It is useful to first examine how an institution comes into existence. There are two general explanations for the genesis of institutions. One is that institutions develop endogenously; that is, they evolve incrementally, based on interaction between people and their physical environment, within their established set of social norms, over a long period of time. The second possibility is that institutions come into existence exogenously, through the external imposition of new rules by powerful groups. However, exogenous rules have been developed endogenously within the dominant group's own particular historical context.

Some institutional economists (see, for example, Menger, 1981) have argued that spontaneous institutions can emerge through the interaction of individuals. However, this view has been subject to strong criticism because it is theoretically impossible to assume an 'institution-free' state of nature in the analysis of the emergence of institutions, and pre-existing institutions must be accounted for in explaining the emergence of an institution (Hodgson, 2003:xii-xv). It is only if an institution-less environment can be discovered that it is theoretically possible to accept spontaneous emergence. Because we cannot assume an 'institution-free' state of nature, in order to understand the process of institutional development, it is useful to concentrate on theories of endogenous institutional development in order to understand institutional development with limited outside influence.

In reality, few societies are without outside influence, however minor. In almost all societies it is the combination of the both endogenous rules (i.e. culture, custom, traditional beliefs) and exogenous rules (i.e. a set of formal laws imposed by a colonial or economic power) that make up the rule set of a particular society. To the extent that imposed institutions, for example, in the case of a colonial state, have been endogenised with pre-existing institutional frameworks to create a new institutional equilibrium will determine the extent to which there is a new known set of rules that guide behaviour in a society. If dual sets of institutions operate side by side with different incentive structures, which could act in diametrically opposed directions, it will be difficult for that particular society to provide a common framework for economically and politically efficient outcomes. This is often the case of developing countries which rely on both traditional and modern economic and political institutional frameworks.

2.2.2 Theories of Institutional Change

There are numerous ways in which the economics literature categorises theories of institutional change. The main competing explanations are the neo-classical economic paradigm, the political economy rational choice theory and the comparative-institutions approach. Sub-section 2.2.2 will outline these competing explanations and then draw some conclusions on the most useful theories for examining institutional change in a developing country context.

The neo-classical theory of institutional change assumes that all evolution is a function of changes in relative prices. Under this general model, utility-maximising agents have an incentive to pursue allocative efficiency by reorganising their production in response to relative price changes (Meier, 2001:27). An example of a neo-classical institutional change theory is the property rights model. In this model, a change in knowledge and the amortisation of property rights reduces transaction costs and changes the incentives to pursue new forms of economic activity. This model is not generally considered a viable explanation for understanding institutional change on the basis that it is too simplistic and assumes that change has resulted from a shift from common to private property rights (Bromley, 1989:14-18). It also does not accept that incentives for societal change are derived from a broad range of non-price factors. The neo-classical institutional view does not have much support as a 'realistic' view of institutional change since it ignores distributional conflicts, power asymmetries and political processes (Meier, 2001:27).

The second broad explanation is the political-economy rational choice model of institutional change, mainly developed by Buchanan (1949, 1954) and Tullock (1976). The political-economy model applies microeconomic principles to political processes and assumes that institutional change is driven by individual actors maximising their own utility. In this theory actors (i.e. politicians, bureaucrats, voters, lobby groups, etc) are assumed to be rational in the sense that they are pursuing given policy preferences based on maximising their own self-interest within the institutions and incentive structures in which they operate (Grindle, 2001:349). The main critique of this approach comes from those that reject the notion that change can be primarily explained by the rational choices of individual actors, rather than individuals as a function of a group and the broader institutional context that actors operate within. For example, Olson (1965) has argued that institutional change occurs as a function of how individuals act collectively, through distributional coalitions with common interests.

The third broad explanation is the comparative-institutionalist approach to understanding institutional change. This approach draws heavily on economic history and sociology. It holds that the resulting institutions in each society are the equilibrium outcome of a game of political, social and economic exchange, where ongoing conflict is placed in the centre of the analysis (Grindle, 2001:351). Under this framework, actions are shaped by the existing institutions themselves and new rules and new institutions can come into existence as a result of historically embedded conflicts (Grindle, 2001:353-358). The comparative-institutionalist theory differs from the political-economy view based on actors being understood to be embedded within historically derived institutions that are in fact the site of ongoing struggles for power. This theory rejects the notion promulgated by political economists that actors are rational individuals that are assumed to be utility-maximising in a purely economic sense.

North (1990, 1991) is one of the main proponents of the comparative-institutionalist view of institutional change. He uses an historical model to explain economic, political and social change by drawing heavily on both transaction cost models of market exchange, the role of informal rules, and the power relations embedded within a society. North argues that institutional change is generally incremental and path dependent, based on changes in transaction costs, technology, and power relationships between different groups competing for resources. Moreover, North contends that the path of institutional development is only efficient if markets are competitive. However, in the more common case that markets are uncompetitive and transaction costs are substantial, the growth path will be determined by the historically derived perceptions of the actors. North recognises that discontinuous change does occur as a result of revolution, but argues that this type of institutional change is the exception rather than the rule.

The concept of 'social capital' describes relationships between groups and has come from the comparative-institutionalist tradition. Collier (1998) defines social capital as the internal social and cultural coherence of society, the norms and values that govern interactions among people, and the institutions in which they are embedded. Fukuyama (2004:32-39) amongst others (see Putnam, 1993), has argued that by building social capital it will contribute to greater social coherence and common interests at the local level, which in turn is considered to be an important prerequisite to generating demand for effective political and economic institutions. Nevertheless, this process of building 'social capital' takes a long time and in common with the development of effective economic institutions, it is the result of the incentives and constraints that exist in that society, and evolves slowly through time.

However, these broad explanations are not all-encompassing theories of institutional change. For example, Grindle (2001:364-366), Wallis and Dollery (1999:118) and the World Bank (1997:124) all maintain that leadership is a key determinant of policy reform, and thus institutional change. However, leadership is not easily accommodated within any of the main explanations of institutional change outlined above. For instance, leadership is irrelevant in the neo-classical model. Similarly, the political-economy tradition assumes that politically led reform would coincide with political self-interest and is uncomfortable with the notion that policy reform and political survival may not coincide. It is interesting to note that many of the reform movements in developing countries have been led by politicians that have faced widespread opposition (Grindle, 2001:365), and therefore cannot be readily explained by this theory. However, Van de Walle (2005:81) argues that this type of extraordinary individual behaviour is a rare luxury, and policies that rely on its existence have a high chance of failure. Moreover, comparative-institutionalism cannot account for the emergence of individual leadership as an autonomous change agent, except to hypothesise that leadership emerges as part of a function of broader group demand.

In the context of developing countries, the comparative-institutionalist approach seems to shed the most light on institutional development and change. This approach stresses the primacy of embedded norms and cultural beliefs and provides a framework that can incorporate both formal and informal institutions which are often diametrically opposed and in competition for legitimacy in developing country contexts. The neo-classical model is limited since it assumes efficient and low transaction cost institutional models - which do not generally exist in developing countries (Hoff and Stiglitz, 2001: 390). The political-economy view has less applicability because it is modelled on Western concepts and traditions of political institutions where politics is society-centric (Grindle, 2001:361) and assumes a certain level of societal organisation in terms of policy-based interest groups. In developing economies with weak society-state contracts, the resulting polity are rarely motivated by broad-based interest groups and party politics, and is more often driven by patronage networks which are embedded in traditional norms and customs (Barkan et al, 2004:220-221).

At one level, the question about which theory is the most useful explanatory approach is a question of timeframes. Neo-classical theories adopt short time horizons to explain change, whilst comparative-institutionalists delve deeper and seek to explain the evolution of institutions over a much longer period of time.

2.2.3 Institutions and Dynamic Change

There is no generally accepted view on the time required for institutions to change. The time period for change depends on the nature of institution under examination and the incentives and constraints in place that act as determinants of change.

In traditional societies, with limited outside influences, societal change occurs very slowly. North (1991) has argued that institutions do not always evolve and may remain static for long periods of time under conditions where innovation is perceived to be a threat to group survival and therefore outside the accepted informal rules of the society. However, in the contemporary world there are few societies which are devoid of outside influence and are more likely to have a number of layers of institutional frameworks. Williamson (2000:278-282) has presented a model of societal change which provides a useful framework for describing the complexity of, and assessment of, institutional change in a modern society.

Williamson's (2000) framework describes four interconnected levels of societal institutions which are expected to fully evolve or transform over differing periods of time. The first level of institutions, described as ‘embedded’ institutions, is comprised of informal institutions that represent customs, beliefs, behavioural norms, religions and traditions. Embedded institutions are expected to change very slowly - between centuries and millennia depending on the scope of external influences on informal societies. The second level of institutions is the formal “rules of the game”, which includes property rights, the development of the polity, the judiciary and the bureaucracy. Change within this level is expected to take at least between ten to one hundred years, depending on the strength of embedded institutions. The third level of institutions seeks to represent the quality of governance, or ‘how the game is played’. The quality of governance is determined by the scale of transaction costs and effectiveness of the enforcement of contracts. The third level is closely related to the second level but can, under certain conditions, evolve more quickly. The fourth level of institutions is described as the production function and is concerned with the efficient allocation of resources, and is continuously changing with the environment and technology.

Williamson’s (2000) framework highlights the complexity and multilayered nature of change processes in developing countries. If his analysis is well founded, the importance of ‘embeddedness’ of culture – where the frequency of change is incredibly slow – should be reflected in any theory or policy designed to influence institutional change.

2.3 Role of the State

This thesis is concerned with understanding the role that institutions play in the process of economic growth and development. Because the state is a key institution in the contemporary world, it is important to examine its appropriate role, and consider to what extent it can assist to build, or hinder the development of, effective institutions.

2.3.1 New Institutional Economics

On the basis of recognition that market failures do occur, neo-classical economic models accepted an increased role for the state. Under this framework, the state was encouraged to undertake a regulatory role to correct for market failures by increasing state interventions to enforce contracts and the provision of government funded goods where externalities were present. In this tradition, it was assumed that the state, treated as a wholly benevolent entity, always made pareto-efficient decisions, which by definition were welfare-maximising for society as a whole.

In the 1950's, criticisms of an increased role for the state emerged which examined the assumptions underpinning economic models by focusing on the incentives and constraints that structure decision-making in the market, and within the state. This tradition, which aimed to bring institutional characteristics back to the core of economic analysis, includes many different strands and has loosely become known as 'new institutional economics' (NIE). NIE has been argued to have a distinct bias towards an inherent belief in the superiority of markets over governments in minimising costs in exchange (Wallis and Dollery, 1999:75-76), and thus assumes non-market failure and prescribes a minimalist role for the state. Frant (1991:118) argued that an NIE approach opens up the "black box of the organisation [the state] by analysing the incentives facing rational individuals". There are a number of core elements of NIE which are now described in turn.

First, transactions costs are defined as the costs involved in the agreement and facilitation of the exchange or transfer of goods and services across technologically separable boundaries (Wallis and Dollery, 1999:66). Coase (1960) demonstrated that allocative efficiency only occurred in economic exchange in the absence of transaction costs. However, in the event of positive transaction costs, the resource allocations brought about by exchange are altered by property rights. Thus, Coase argued that agents will use either the market or firms to minimise the costs of economic exchange. Coase's theory rejected Pigou's theory of property rights that posited government intervention as the efficient solution to the failure of property rights (Mueller, 2003:28).

A second element of NIE is agency theory. Wallis and Dollery (1999:68) define agency theory as being "concerned with the ways in which one economic agent [the principal] can design and implement a contractual compensation system to motivate another economic agent [the agent] to act in the principal's pecuniary interests". This assumes that there will always be informational asymmetries between the principal and the agent which will allow the agent to engage in opportunistic behaviour that alters the allocation of economic resources in favour of the agent. Agency problems can occur between the firm and shareholder; voter and politician, and, bureaucrat and politician, and result in non-optimal economic outcomes. Fukuyama (2004:47-48) describes principal–agent problems as the overarching framework for understanding governance problems in a modern state (see also World Bank, 2005: 280-283). For example, in a democratic political system if there is no way in which voters can contract their elected politicians to act in the interests of the electorate, then they may generate a failure of governance. Keefer and Khemani (2005:1-2) further argue that due to the imperfections in the political market (i.e. lack of voter information about politicians' performance, social fragmentation and limited credibility of election promises) that politicians often face stronger incentives to extract rents and distribute them in favour of small interest groups than to act in the larger group's interests. This suggests that poor service provision is often not a result of a lack of demand from citizens, but the failure of the political market.

A third strand generally considered to sit within the NIE paradigm is public choice theory. Public choice theory simply applies the *homo economicus* methodology to political processes, like "the theory of the state, voting rules, voting behaviour, party politics and so on" (Mueller, 2003:1). It strongly rejects the notion of the benevolent state and instead assumes that voters, politicians, bureaucrats and members of special interest groups should be treated as rational utility-maximisers (Wallis and Dollery, 1999:56). Public choice theory identifies a number of sources of state failure which derive from the agents acting in their own interests. First, legislative failure results in allocative inefficiency by transferring public resources to their special interest groups in a way that maximises the chances of a politicians' own re-election rather than on a pareto-efficient basis. Second, bureaucratic failure occurs as a result of bureaucrats lacking the incentives to efficiently implement policies that are not in their direct interests. The third source of government failure is rent-seeking as a consequence of government being viewed as a wealth transferring agent able to transfer resources to pursue private interests.

NIE generally rejects the benevolent state as the contracting agent concerned with social welfare and instead assumes a form of 'predatory' state. There are three core theoretical variants of the predatory state (Wallis and Dollery, 1999: 34). The first variant is the autonomous state theory which views the state as a revenue-maximising agent for the group in power, without regard for social welfare of society as a whole. The second is the regulatory-capture or interest group theory that views the state as the institution through which economic interest groups contest public policy and resulting resource allocations. The third variant is the self-seeking bureaucrats' theory that assumes bureaucrats seek to maximise their own welfare. All draw on, to varying degrees, public choice theory to underscore the nature of government failure in predatory or semi-predatory states. In sum, NIE advocates a minimal rather than maximal role for the state because the state will tend to over expand. This view is based on the assumption that the state, and the various actors that control the state, will engage in rent-seeking behaviour which maximises their own utility, rather than promoting resource allocations that provide the optimal conditions for economic growth.

Alternatively, normative theories of government failure could be applied to assess the appropriate role of the state. Compared to positive theories, normative theories aim to provide a framework against which actual behaviour can be assessed, and in this case so that comparisons between markets and governments can be made more intelligently. Wolf's theory (1979, 1993) of non-market failure is one of the most comprehensive (Wallis and Dollery, 1999:46-46). Wolf identified the attributes of non-market (government) demand and supply that create the conditions for reduced allocative efficiency and distributional equity. These demand and supply characterises include the premature but effective demand for government intervention, the difficulty of defining and measuring output, the lack of 'bottom line' indicators (for example, profit) to determine performance, absence of competition of supply, and lack of an effective termination mechanism for output (1979:112-115; 1993:35-55).

Wolf (1979, 1993) outlined four types and sources of non-market failure. The first type of failure is the presence of 'internalities', defined as "the goals that apply within non-market organisations to guide, regulate, and evaluate agency performance and the performance of agency personnel". He further argued that internalities alter non-market output away from what is socially desirable to the private goals of the agencies, and this has the effect of boosting "agency supply curves above what is technically feasible", for instance, through larger agency budgets, technology, information acquisition and control (1979:116-123). The second type of failure is the "disjunction between costs and revenues and redundant and rising costs" and is a consequence of the difficulty of determining appropriate levels of outputs, thereby allowing agencies to move towards inflated internal agency goals. The third type of identified failure is derived externalities which result from the unanticipated consequences of government intervention. Failure results from incomplete costs-benefit analysis and is typically exacerbated by political pressure and the short-time horizons and high time discounts of political actors. The final type of non-market failure comes from distributional inequities indexed on the power and privilege of position. An example of this type of failure is a government minister granting a monopoly import license to a company where s/he directly benefits. In developing countries, where political and social markets (for example, informational media) are undeveloped, this type of failure is common. Wolf's non-market failure taxonomy is further examined in the context of aid interventions in Chapter 4.

Wallis and Dollery (1999:54) argue that the rise of government (state) failure literature has "ignited a search for ways of reducing the extent and magnitude of government". The policy push from international organisations to minimise the functions of the state has been applied most strongly in the case of fragile states that most often exhibit high rates of non-market failure.

2.3.2 Emerging Consensus

The original economic conception of the role of the state was put forward by Musgrave (1959). Musgrave argued that a state should engage in macroeconomic stabilisation, income redistribution and resource allocation. More recently a growing consensus on the role of the state has emerged. In the policy world, this has mostly been promulgated by the World Bank (1997;30-33) which proposed that there is an economic rationale that should underpin the question of the appropriate role of the state. This rationale proposes that the core purpose of the state is to correct for market failures and improve equity. However, the actual functions of an individual state should be based on each state's own capacity to effectively undertake a hierarchy of functions. Thus, states with low capacity should only seek to fulfill minimalist state functions before they pursue activist state functions as set out in Table 1 below.

Table 1: Functions of the State

	Addressing market failure			Improving equity
Minimal functions	Providing pure public goods: Defense Law and Order Property Rights Macroeconomic management Public health			Protecting the poor: Antipoverty programs Disaster Relief
Intermediate functions	Addressing Externalities: Basic education Environmental protection	Regulating Monopoly: Utility regulation Antitrust policy	Overcoming imperfect information: Insurance (health, life, pensions) Financial regulation Consumer	Providing social insurance: Redistributive pensions Family allowances Unemployment insurance
Activist functions	Coordinating private activity: Fostering markets Cluster activities			Redistribution: Asset redistribution

Source: World Bank (1997:27)

This World Bank (1997) led view on the role of the state has become the new conventional wisdom in development policy (see for instance, Fukuyama, 2004) Matching functions to capabilities is premised on the rationale that a developing state has a greater chance of its institutions functioning effectively if they are not overloaded. This model prescribes a minimalist role for states with weak capabilities and poor governance, to both improve the efficiency of resource allocations and to seek to reduce the incidence of non-market failure as described in section 2.3.1. This view of the role of the state is broadly consistent with NIE.

2.4 Influencing Institutional Development

This section is concerned with how institutional development, in particular the development of the state can be positively shaped. The institutional economics literature has not come up with any ready formula. In short, the literature concludes that institutional development is complex and long-term. Western history has shown that the development of effective macro-institutions that can play a positive role in facilitating economic growth and development for a society can take hundreds, if not thousands, of years to develop.

Adopting a comparative-institutional framework, the development and evolution of institutions is "overwhelmingly incremental" path-dependent and results from increasing returns and imperfect markets with high transaction costs (North, 1990:89-96). According to this view, the only way to fundamentally shape institutions is for actors to seek to influence the political and economic framework through a gradual process of bargaining between actors competing for marginal economic gains over a long period of time. In essence, this theory contends that all 'real' change of institutions is endogenous. For example, drawing on the historical example of the demise of feudalism and rise of land ownership, North (1990:89) has argued that the opportunity for the evolution of institutions resulted from environmental changes (such as population changes and development of technology) which led to thousands of incremental alternations in the economic exchange between lord and serf, and eventually a fundamental institutional change in land ownership.

North (1990:90) contends that discontinuous change which results in a rapid and fundamental shift in the rules of a society is rare. He further argues that if fundamental change does occur the institution transplanted by the discontinuous change is usually not sustainable. This is because the coalitions necessary for the change are often engaged in conflict over payoffs in exchange for effecting the change.

Is there scope for these embedded and incremental processes of change to be successfully pursued in a state context? This section will next explore a few possibilities.

The first possibility for effecting change in the state is through an 'actor-driven' shift in structures mediated through existing institutions (i.e. political and bureaucratic institutions of state). For example, an individual may be motivated to foster a group to push for reforms that change the incentive structures in society. However, in section 2.2 we noted that individual leadership cannot be relied on as a theory of change because it is extraordinary.

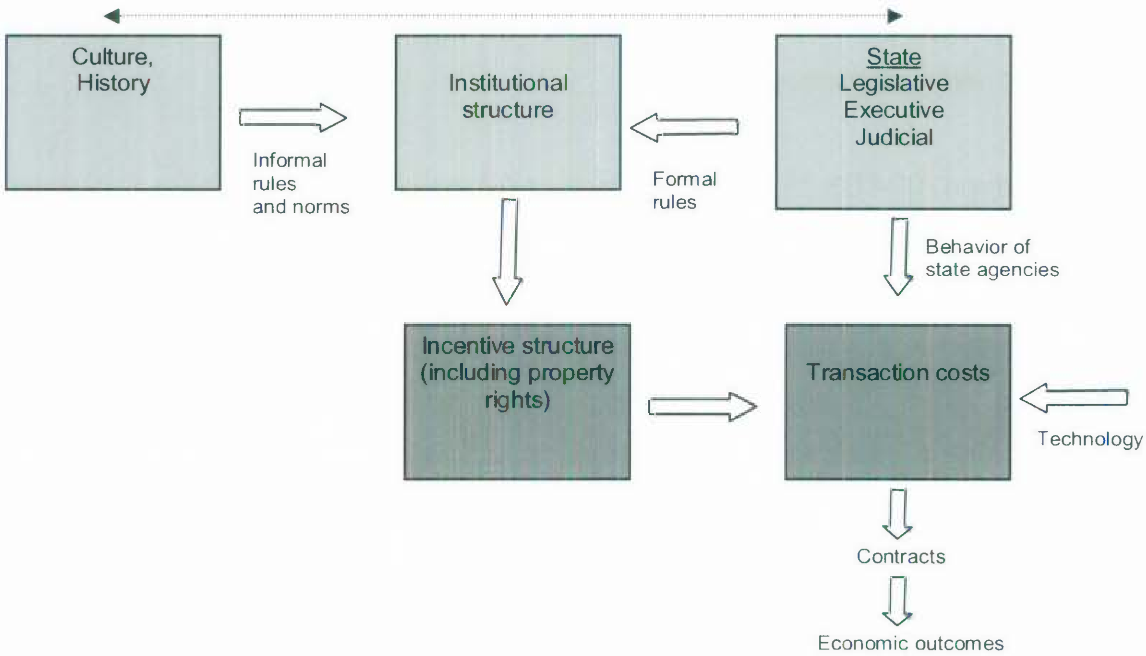
Drawing on Olson (1965, 1982), 'privileged' groups are more effective at achieving collective action because there is at least one member with an incentive to see that the collective good is acquired, with minimal level of organisation or coordination required. But in the absence of this abovementioned reform-minded idealised group, history has shown that pareto-maximising policy reform is most likely to emanate from larger groups, which Olson characterises as 'latent' groups (1965:50-51), and once these larger groups take on an organisational form, 'encompassing coalitions' (1982:47-53), for example, through large worker unions such as the Zambia Congress of Trade Unions (Van de Walle, 2005:27). Moreover, Olson (1965:50-51) has argued that the incentive for individuals to join 'latent' groups, and exert effort in the collective good is low because of the small relative size of the gains. Therefore influencing policy reform through these groups is difficult, and incremental. In a latent group, only where there is a 'selective' incentive (for example, prestige), or compulsion, will a rational individual be motivated to act in the group's interests, thus empowering the group. Mobilised latent groups, because of their size, can exert power to bargain and change policy outcomes. In any case, small privileged groups, usually pursuing distributional ends, are more likely to be successful at pursuing their common interests than large ones. Traditional and transitional societies are usually characterised by a large number of small groups that are typically pursuing distributional ends, which on balance are wealth reducing for society as a whole.

Reform-minded individuals and groups could also seek to increase information flows, within the confines of bounded rationality, over the role of the state and how the state's resources are actually used. Over time, increased information flows (i.e. through programs of civic education and participatory budgeting) could reduce information asymmetries between voter, bureaucrat and politician, by slowly changing the nature of the agent's incentives. Proponents of 'actor-driven' theories of change accept that behaviourial norms change slowly and that to properly secure the reforms, pressure for change needs to emanate from different levels of society.

Fukuyama (2004:32-35) makes the forceful point that broad-based domestic demand for reform of institutions is crucial for sustained reform. He further emphasises that in the majority of cases of successful state institution building (i.e. resulted in institutions that positively influence economic performance) has occurred when society has generated strong demand for these institutions. Despite these sentiments, Fukuyama's thesis fails to explain how demand for institutional reform arises in weak and predatory states. Drawing on Olson's theory of groups, broad-based domestic demand will only emerge when there is a selective incentive for an individual to mobilise large groups of voters, workers or consumers.

The second possibility for influencing state change is through modifying the formal rules, or structures of a society. Using the illustration of the state polity legislating to change the formal rules in a state, we cannot assume that actual institutional reform will naturally follow the formal rules. For example, this form of structural change assumes that acts which may be common practice in traditional societies will be reduced with the introduction of new legislation that prohibits certain acts. Drawing on section 2.1, it is only if these prohibited acts are accepted as being illegal by society that changing the formal rules will actually result in a modification in the incentives to perform particular acts. Changing structures without broad-based support, or a degree of endogenisation of evolved structures, is unlikely to result in much change in the actual legitimacy of the institutions that exist in a society. The relationship between informal and formal institutions and the need to shift incentives within both sets of institutions to influence reform in the state is set out in Figure 1 below.

Figure 1: The State, Institutions and Economic Outcomes



Source: World Bank (1997:30)

In essence, new institutional economics does not support the idea of relatively quick and fundamental reform of the formal institutions that exist within a state. Economists from other traditions however, are more optimistic about the scope for change. For example, concentrating on reform of the state, Meier (2001:35-39) proposes that large innovative change is possible if actors (including external actors) seeking to influence positive institutional reform have a 'high' understanding of the policy-making process and better utilise political processes to influence outcomes. Meier's (2001) argument places substantial faith in political actors to take advantage of critical moments (i.e. the times when policy changes occur) to make positive structural changes. Meier's optimism for big-bang reform, or discontinuous change, does not enjoy broad support in the institutional economics literature.

A third option for influencing change is through the use of 'systems' and 'networks'. Systems theory has emerged out of the critique of traditional aid approaches and "starts from the premise that it makes little sense to build capacity from the outside in the absence of supporting conditions" (Bossuyt, 2001:9). This approach draws on the comparative-institutional tradition, and lends well to developing countries, due to its central focus on relationships, informal exchange and non-linear change processes. Morgan et al (2005) have proposed that by focusing on systems behaviour, which is driven by "shared interests and identity, information, processes and relationships" there is potentially more scope for improving capacity in developing countries than through conventional models. In sum, a systems approach seeks to build the capacity of society endogenously. Drawing on case studies Tascheraeu and Bolger (2005:6) have argued that networks emerge and develop from both endogenous and exogenous factors. Endogenous sources include pre-existing social capital, the opening of political space and factors such as leadership. Exogenous factors includes access to external resources (i.e. knowledge, funding), facilitation of exchange, and external interventions that help to open up political space. This analysis suggests there may be a useful role donors can play to externally support and nurture networks.

2.5 Concluding Remarks

By way of a conclusion to this broad review of the institutional economics literature, it is worthwhile drawing some central lessons that seem important to our understanding of institutions in economic development.

First, it is essential to understand the incentive frameworks that exist in a society in order to comprehend why actors make the decisions that they do. The review of the literature conducted in this chapter portrays the comparative-institutional tradition of institutional development and change in a more positive light than other approaches. Comparative-institutionalists draw on a number of disciplines to understand and explain change processes, whilst the neo-classical and political-economists use economic models which always portray people as utility maximises, without regard for the broader social and political structures that motivate behaviour.

Second, the modern state is made up of a complex blend of formal and informal institutions. Where the formal rules of state have evolved endogenously over a long period of time, the resultant societal institutions are more likely to reflect the informal institutions. In the case where there is a large gap between the informal (or endogenously created) institutions and the formal institutions (sometimes exogenously adopted) the informal institutions are more likely to predominate. Under these circumstances, where overlapping incentives exist, neither institution is likely to function very effectively, reducing the potential for sustained economic growth. The challenge for those advocating for reform in transitional states is to seek a compromise between the two overlapping sets of institutions to ensure there is a commonly understood set of incentives and constraints that can provide a more certain environment for economic activity.

Third, if the objective of the state is to provide a framework for economic growth and development for all of its citizens, institutional economic theorists generally support a minimal rather than maximal role for the state due to its lack of capacity, and general tendency to create non-market failures. A framework for developing country institutional reform is further explored in chapters 3 and 4.

Finally, few disagree that the process of institutional change is slow and incremental. Analysis of the Western economic system indicates that the evolution of effective modern institutions have taken from centuries to millennia to evolve into their modern shape (see Chang, 2001). Fundamental change is difficult to affect and sustain, and is likely to be short lived if the institutional framework is not understood or accepted by both the state and its citizens. Chapter 3 will explore international aid donor's literature on institutional change and how institutions provide the basic building blocks for better governance, and ultimately, economic growth and development.